

LITHUANIAN FREE MARKET INSTITUTE

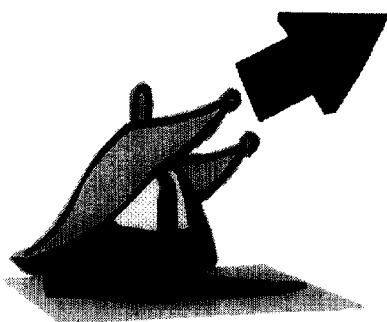
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FINAL REPORT

1 September 1996 – 31 March 2000

**Free Market for Lithuania's
Prosperity**

[Agreement No 181-A-00-96-90322]



**Vilnius
2000**

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The Lithuanian Free Market Institute (LFMI) is an independent non-profit organization founded in 1990 to promote the ideas of economic liberalism, based on the principles of individual freedom and responsibility, free market and limited government, as well as to formulate a sound and innovative approach to economic policy.

From September 1, 1996 until March 31, 2000, LFMI conducted a USAID-funded project "Free Market For Lithuania's Prosperity." The purpose of the project was to provide independent expert input into the economic reform process in Lithuania and to promote the adoption of free-market-oriented legislation for the purpose of creating an environment supportive of private business initiative and increasing the size and contribution of the private sector in the Lithuanian economy. LFMI pursued these goals via research, policy advocacy and public education. The areas of activity comprised financial infrastructure, tax and budget policy, monetary policy and banking, and private enterprise. Under a workplan starting July 1998, the project activities focused on private pension insurance, capital markets, privatization, use of proceeds from privatization, leasing, and company law.

LFMI carried out a series of activities to accomplish the goals of the project. LFMI conducted high-quality research and policy analysis and submitted recommendations on a variety of economic policy issues with a considerable impact on policy debates and the legislative outcome. To promote the adoption of sound legislation and gain passage for promoted changes, LFMI experts participated in governmental policy-drafting groups and testified before the cabinet, parliamentary committees and ministerial groups. Co-operation with business organizations, foreign experts and international financial institutions was a significant part of LFMI's efforts. Intensive media campaigns were launched to raise public awareness of the issues addressed, to build broad-based community support for the proposed changes, and to urge policy action.

Policy recommendation versus legislative action

I. Financial Infrastructure

One of the goals of the project was to promote the development of financial infrastructure and an efficient allocation of resources. LFMI's activities in this area focused on privatization legislation, the introduction of private pension insurance, the preparation of the legal structure for leasing, and analysis of barriers to capital market development.

Private pension insurance

The promotion of private pension insurance was one of the major objectives of the project. After years of intense policy debates, on 3 June 1999 the Law on Pension Funds was passed, providing a legal basis for voluntary fully funded pension insurance through private pension funds. Private pension funds are expected to facilitate retirement provision, to provide relief within the fraying social security system, and to stimulate capital markets. The law, which came into force on January

1, 2000, is based largely on the proposal formulated by LFMI. LFMI provided decisive input to the law-drafting process, seeking to secure transparency and financial soundness of pension funds as well as affordability of private retirement provision for middle-income individuals. LFMI promoted a maximum reliance on market forces, extensive investment in wide-ranging financial instruments and internal risk control mechanisms as the cornerstones of a credible and sustainable operation of pension funds. During the policy-drafting process, LFMI co-operated with the parliamentary Budget and Finance Committee, the Ministry of Social Security and Labor, the Securities Commission, the World Bank, and other interested institutions. A series of policy papers, evaluations and testimonies was provided.

Two major conferences on private pension funds organized by LFMI played a key role in furthering the policy-drafting process. The first conference, "Private Pension Funds: Laying the Foundations," was held in March 1997 in co-operation with the Social Policy Unit and with co-funding from the International Center for Economic Growth, USAID, and the United Nations Development Program. The other policy forum was held in the parliament of Lithuania in November 1998, in co-operation with the parliamentary Budget and Finance Committee. The events drew over 70 participants each, including members of parliament, top government executives, including Social Security and Labor Minister Degutienė and Finance Vice-Minister Urbšienė, pension and capital market specialists, and leading reporters. The 1998 conference helped to gain passage for a number of necessary amendments to the legal structure for pension funds activity.

Pension fund supervision

Seeking to promote the creation of a complete, functioning basis for the operation of pension funds, LFMI worked out and submitted to decision-making institutions a package of policy recommendations for building prudent and effective supervision of pension funds. The policy package comprised a study on pension fund risks and risk management mechanisms, a comprehensive conceptual framework for pension fund supervision, and specific policy proposals for the supervisory system in Lithuania. LFMI drew on a comprehensive approach to supervision, defining it as a complex of factors determining a smooth operation of pension funds. These include a proper legislative framework providing for the functioning of self-regulatory market mechanisms, activities of professional associations, existing business standards, and state control. LFMI contribution provided a solid basis for informed policy debates and the adoption of needed legal acts. Specifically, they were utilized in drafting supporting legislation on pension programs, pension contracts, licensing rules, asset valuation, formation of reserves, the assignment of supervisory responsibilities, and others.

Privatization legislation

The second phase of privatization of state and municipal property faced a dramatic slow-down, revealing a range of deficiencies and inconsistencies in the legal framework. LFMI exerted a major influence on the improvement of the Law on Privatization of State and Municipal Property and related legal acts by analyzing the legislation and developing a package of comprehensive policy advice. The main problems of the privatization process were attributed to (i) discretionary right of founder ministries and municipalities to release property for privatization and to select the method of privatization, (ii) vague objectives and powers of privatization institutions, and (iii) disregard of private subjects in organizing privatization. The institute urged the government to provide for automatic release of property by establishing clear-cut criteria and terms of privatization, to clearly define the functions of privatization institutions, to involve private subjects in the privatization process, to revise the methods of privatization and to use a public sales of shares on the stock exchange as the most efficient way of privatizing state property.

In early 1997 and in the second half of 1998, LFMI disseminated repeatedly a package of proposals for increasing transparency, efficiency and fairness of privatization. LFMI gained important allies as

the National Stock Exchange, the Securities Commission and the National Financial Brokers Association upheld its recommendations. In response, the government began to rely more on privatization through the stock exchange and reduced the level of discretion attached to tenders.

The methods of privatization

LFMI conducted research on the methods of privatization from the perspective of their results and implications for the country's economy. LFMI investigated the conditions under which specific methods are used as well as criteria that determine the choice of the privatization method. The aim was to identify the weaknesses of the existing methods and to promote the use of the most effective ones. Research conclusions and policy proposals, plus data on the results of the privatization process and some foreign evidence, were presented in a comprehensive policy study. The study was submitted to all interested institutions. It is expected to stimulate policy debates and decisions to eliminate the defects of the methods applied in Lithuania and to promote a greater reliance on the stock exchange in order to increase efficiency and transparency of the privatization process.

Compensation of depreciated savings

LFMI exerted a major influence on policy debates regarding compensation of residents' savings lost to ruble depreciation. LFMI analyzed the government's proposal for the compensation program and opposed in an extensive policy advocacy campaign the provisions allowing the compensation fund to take loans with government guarantees, the use of state budgetary resources for compensation purposes, accrual of interest on realistically non-existent deposits, and unregulated and unlimited government borrowing by pledging state assets. As a direct result of these efforts, borrowing with government guarantees for the compensation fund was prohibited, the compensation fund was separated from the state budget, and the accrual of interest on compensation deposits was outlawed. A series of subsequent testimonies helped to ensure that the level of borrowing was limited and the Savings Bank was deprived of its exceptional right to extend loans to the government. This was one of the major accomplishments of LFMI.

The use of proceeds from privatization

According to the functioning legislation, two thirds of privatization income must be allocated for compensation of residents' savings lost to ruble depreciation, and one third must go towards financing economic programs. LFMI aimed to promote prudent decisions regarding the allocation of revenues from privatization with the least negative effect on economic processes and market participants. LFMI made analysis of possible uses of privatization proceeds and their likely effects on the country's economy and formulated recommendations regarding the most appropriate allocation of the resources. LFMI framed different models of the use of proceeds from privatization, depending on what impact they would produce on the economy. Research findings and conclusions were presented in a policy study that was submitted to the Government, parliamentary committees and factions, related ministries, and the International Monetary Fund.

The compensation program creates conditions for the completion of privatization by transferring the money from privatization to private hands. LFMI pointed to the need to reconsider the use of the remaining one third of proceeds from privatization, to revoke the financing of economic programs and to reduce state liabilities. Given that privatization has still large potential and will generate substantial revenues, LFMI proposed that privatization income be used for pension reform, repayment of state debt or other general needs of the country. The inflow of privatization revenues provides a unique opportunity to reform the social security system and to finance the transition to private pension insurance. This position is widely upheld by economic experts and is gaining support from different decision-making authorities.

On November 24, 1999 the parliament passed legislative amendments by which compensation of depreciated savings was suspended for two years. The proposal to use privatization revenues for pension reform is now widely supported and debated.

Leasing

Leasing is one of the most important new financial products that are being introduced in Lithuania. With minor changes to the Civil Code, an appropriate legal structure for the leasing system could be prepared. A new law was likely to impose too many limitations and government interference. LFMI sought to prevent the introduction of excessive regulations and restrictions on leasing as well as to advocate replacement of tax regulations discriminating against leasing activity. Following policy advice from LFMI, a draft law on leasing, which prescribed too many restrictions on leasing, was rejected. Necessary provisions on leasing were incorporated in a new supplement to the Civil Code. Consistent with LFMI's recommendations, restrictions imposed on the objects of leasing and the lessor were removed. Leasing for consumption purposes was authorized. Leasing contracts were simplified. A number of technical changes to the formulated provisions were made.

In addition, LFMI assisted the Finance Ministry in formulating tax rules for leasing activity. The government adopted a decree, simplifying VAT regulations and improving the procedures for VAT drawback applicable to leasing companies.

Barriers to capital market development

Although the Lithuanian capital market has been operating since 1993, it is still fairly weak. There is a whole range of statutory and regulatory restrictions and unfavorable government policies that pose serious obstacles to the development of the capital market. The main problems include a lack of institutional investors, over-restrictive regulations of capital market participants (investors, issuers, financial intermediaries), failure to use the stock exchange for the privatization of state property, and others. LFMI conducted research on the barriers to capital market development stemming from the legislative and regulatory framework, state supervision, and related government policies. In January 2000, LFMI held a round-table discussion on impediments to capital market growth. The seminar drew about 40 participants from the National Stock Exchange of Lithuania, the Securities Commission, the Central Securities Depository, financial brokerage firms, investment and insurance companies, banks, and private corporations. The round table provided first-hand information on barriers to the operation of capital markets and served as a platform for an exchange of opinion. The results of the discussions were utilized in the LFMI policy study, which was submitted to the aforesaid institutions and private sector participants. It is expected to further the adoption of changes that are essential for accelerating the growth of capital markets.

II. Tax and Budget Policy

Tax and budget policy was one of the main areas of the project activities. During the course of the project, LFMI addressed a whole range of fiscal policy issues and achieved a number of significant accomplishments. The goal was to promote a fundamental revision of Lithuania's arcane and unwieldy tax code and the principles of budget formation, seeking to reduce the tax burden and the level of redistribution.

A proposal for tax and budget reform

LFMI developed and proposed a conceptual framework and program for tax and budget reform. The proposed reform is designed to lift and even out the tax burden, to minimize its destructive effects on market processes, to reduce administrative costs and to curtail redistribution. The centerpiece of the proposed tax reform is the abolition of income taxation in favor of a uniform

VAT-based tax. Following an extensive dissemination campaign, including a major conference in December 1997, numerous policy briefings and expert testimonies, LFMI's proposals resonated loudly with the business community and political circles, provoking intense discussions and setting the frame of policy debates on tax reform.

LFMI exerted a profound influence on the seventh administration's program. The introduction of progressive income taxation was prevented. Reinvested profits were exempted from the corporation tax in 1997, a primary measure that had been proposed and advocated for years by LFMI in order to promote investment and accelerate business growth. Discrepancies relating to tax breaks were removed, and the Law on Foreign Investment was amended accordingly, scrapping all forms of tax relief for foreign capital and putting all businesses on an equal footing.

In the second half of 1998, the government changed fundamentally its approach to tax reform and switched from unsystematic decision making to consistent policy actions. The government adopted a program for revising tax legislation that endorsed almost all principles of a tax system proposed by LFMI. They included: fairness, equality, neutrality, clarity, transparency, and effective tax administration. The abolition of the corporate income tax was included in the eighth government's program but, in light of the economic crisis and falling budget revenues, this plan was replaced with a proposal to reduce the rate of the corporation tax.

Budget reform

It is essential that tax reform go hand in hand with changes to budgetary policy and public spending. This would create conditions for lifting the tax burden and curtailing redistribution. After LFMI put forward a proposal for a fundamental revision of budget policy in 1996, lawmakers huddled with LFMI's policy experts to develop a conceptual framework for reform. As a result of this initiative and LFMI's analysis of the 1998 budget proposal, groundbreaking changes were launched in 1998, providing for a balanced budget, the abolition of 18 extra-budgetary funds, program budgeting, and increased transparency of public spending.

Yet, the state budget still fails to reflect the reforms and privatization of state property and functions that have been conducted to date. The need remains to define functions that must continue to receive government funding, functions that should be terminated without further delays and functions that should be gradually privatized. LFMI's efforts have been instrumental in promoting a sound attitude to tax reform that relates tax cuts to the need to revise and reduce state functions.

Income taxation

LFMI contributed significantly to the improvement of new draft laws on corporate and personal income taxes. LFMI actively participated in a policy-drafting group of the Ministry of Finance, held regular meetings with cabinet members and submitted a number of evaluations and proposals. This helped to ensure that widely promoted and politically accepted conceptual provisions be properly embodied in the legislation. Over 15 fundamental proposals from LFMI were adopted, including the elimination of unjustified tax breaks for businesses, increased procedural transparency of income and cost recognition, and recognition of loans, losses, and representation costs. Proposals from LFMI were also utilized in deliberations on the concepts of corporate tax and the taxpayer, taxable and tax-exempt income, tax rates, non-performing loans, and reappraisal of fixed investment capital. The most essential changes to personal income taxation were an expanded tax base and modified tax computation and compliance procedures. However, the adoption of the new laws has been postponed repeatedly and the policy debates continue. Significant changes are expected under a new governmental initiative, called a Sunset program. This program is aimed at improving business conditions in many vital areas. LFMI is leading the work in the area of taxation.

Inheritance and gift tax

On 1 January 1998, inheritance and gift taxes were introduced in Lithuania. LFMI launched an extensive media campaign to explain that inheritance and gift taxes are the most discriminatory and destructive of all property taxes and undermine the institution of private ownership. These efforts provoked intense public debates. In response to public pressure, the parliament reduced the tax rate from 20 to 10 percent and fully exempted close relatives from the tax.

Capital gains tax

In mid-1998, the parliament passed the controversial amendments to the law on personal and corporate income tax, imposing a tax on dividends and capital gains. LFMI opposed the introduction of the tax, arguing that it would hamper the development of the capital market and that any revenues generated from it would be offset by the administrative costs. LFMI consolidated efforts with the National Stock Brokers Association and market experts, seeking to revoke the tax. As a result of a meeting with the veto-empowered President Valdas Adamkus, a compromise was reached that was overwhelmingly approved by parliament. A 15-percent capital gains tax was adopted instead of the original 29 percent, and a minimum tax-exempt level was set.

Real estate tax

As a direct result of LFMI's opposition, the introduction of the real estate tax for individuals was suspended twice, preventing an increase in the general tax burden and the infringement on the institution of private ownership.

Stamp duty

In 1998, LFMI submitted to the government a project of amendments to the stamp duty legislation, seeking that (i) stamp duties are paid by direct recipients of the public services for which stamp duties are charged, (ii) the size of stamp duties reflects the costs of public services, and (iii) receipts from stamp duties go toward financing the institutions that provide the services. As a result, the government decided to charge a uniform stamp duty for licenses issued to passenger transportation companies. However, the initiated revision of the stamp duty legislation was suspended.

Tax administration

In 1994, LFMI brought forward a proposal to unify the tax collection mechanisms of the Tax Inspectorate and the State Social Insurance Fund in order to trim public spending and to rationalize tax administration. As a result of continued pressure from LFMI, in 1997 the cabinet endorsed the unification of the information systems of the Tax Inspectorate and the State Social Insurance Fund. In early 2000, the government adopted a decision to consolidate the tax collection mechanisms. The Ministry of Finance is now preparing a conceptual framework for the unification.

Fiscal decentralization

Consistent with its program for budget reform and the promotion of efficient allocation of resources, LFMI worked out and submitted to decision-making authorities a reform proposal for fiscal decentralization. It comprised exhaustive recommendations for the assignment of responsibility between tiers of government, transfer of state-owned property to municipalities, privatization of municipal functions and assets, and application of tenders in municipal service delivery. This initiative drew the policy community's attention to the problems confronting the process of fiscal decentralization in Lithuania and contributed to better-informed debates. LFMI helped to draft a new methodology of defining local government revenues and expenditures. The new methodology provided for a sounder equalization of income among municipalities but failed to enhance fiscal decentralization and independent, responsible local government. This remains the main target for reform in the area of self-government.

III. Private Enterprise

LFMI carried out a series of activities to contribute to the creation of favorable conditions for private business activity, to expand freedom of action and competition, to abolish barriers to market entry and operational business constraints, and to limit state interventions in economic affairs.

Business growth in Lithuania is shackled by excessive government regulations, including barriers to market entry, unjustified licensing requirements and employment regulations, the arcane tax code, and government interference in the economy. Rather than granting special favors to narrow groups at the expense of others and thus violating free competition, it is necessary to improve the general business environment, to ensure protection of private ownership, and to reduce government interventions. LFMI acted on this belief as it challenged repeated attempts of the government to expand corporate welfare programs under a new legislation on small and medium-sized business (SME). In response to compelling policy papers and testimonies from LFMI, legislative proposals on SME from the Economic Ministry were declined twice, in late 1996 and in 1997. In 1997, LFMI exerted a major influence on policy debates. The government adopted a new approach to business development, involving the conversion of specific tax and regulatory favors to general tax cuts and regulatory relief. Still, in November 1998 a law on SME development was passed, outlining general provisions on state aid for SME.

In 1998, LFMI led a successful campaign against a draft law on disqualification of enterprise managers, proposing unjustified, discriminative penalties for managing personnel for inadequate business decisions without instituting court proceedings.

A groundbreaking program for improving business conditions and removing unjustified government regulations has been prepared under a recently launched Sunset initiative. LFMI is leading the work of a task force formulating proposals for eliminating regulatory barriers to private business activity.

Company law

LFMI initiated fundamental revision of the law on joint stock companies, which prescribed unjustified restrictions on enterprise's internal management, ownership rights, distribution of profits, lending, borrowing, and investment activity. LFMI prepared a project of amendments aimed to strengthen corporate governance and enhance private sector activity by letting companies determine their own internal structures, not limiting borrowing to the level of capital, allowing companies to be debtors and creditors, eliminating restrictions on enterprise investments, simplifying procedures for merger and acquisition, etc. This proposal was approved by a working group under the auspices of the president of Lithuania and supported by the Lithuanian Industrialists Confederation. Following consultations and revisions, in December 1998 the president submitted the proposal to the government and the parliament of Lithuania for urgent consideration. After debates, the parliament decided not to consider the proposal at short notice and recommended that the proposed amendments be included in a new draft law on joint stock companies prepared by the Economic Ministry. LFMI continues to influence the policy debates and co-operate with interested institutions.

In September 1999, the parliament passed amendments to the company law, eliminating restrictions on enterprise borrowing. The new draft law is scheduled for parliamentary debates by mid-summer. LFMI will continue to press for necessary changes.

Enterprise bankruptcy

In 1996, LFMI evaluated a draft law on enterprise bankruptcy and submitted a package of comprehensive proposals to the Economic Ministry. All recommendations from LFMI were incorporated in the final version of the law adopted by the parliament. The main provisions related

to the rights of enterprise owners regarding the instituting bankruptcy proceedings, the order of satisfying creditors' claims, and the terms of instituting bankruptcy proceedings in agricultural companies.

Competition

In early 1999, LFMI exerted a profound influence on policy debates regarding competition principles. In a series of policy papers and expert testimonies, LFMI opposed the state's involvement in business affairs and powers to dispense aid and favors as prime factors violating the rules of free competition. LFMI advocated freedom of contract and the removal of barriers to market entry and technological regulations. As a result, certain operational restraints were lifted and responsibility for violations of competition on the part of governmental agencies was spelled out. The formerly government-controlled Competition and Consumer Protection Service became an independent institution, which was a vital step in safeguarding competition against government-effected violations.

IV. Monetary Policy and Banking

LFMI has worked to preserve a transparent, reliable and rule-bound monetary policy protected from political pressure and private interests.

The plans to phase out the currency board and to restore a "classical" central bank, which were adopted by the Bank of Lithuania in early 1997, prompted a barrage of criticism from the Lithuania business community and international organizations. The program also provided for repealing one hundred percent reserves and replacing the anchor currency. In an extensive policy advocacy campaign, LFMI stressed that strict currency-board principles were essential in reducing the likelihood of money inflation and government interference in economic affairs. As the crisis in Russia built up, decision-makers in Lithuania began to recognize that a sound money protected from political pressure was the only anchor against economic turmoil and instability. As a result, the official position has changed in favor of maintaining the currency board. The replacement of the anchor currency with the euro is scheduled for mid-2001.

In the area of commercial banking, LFMI contributed to the authorization of bank loans in foreign currencies and the improvement of provisions on deposit insurance, disclosure forms for commercial banks and the rules of opening and holding bank accounts.

V. Social Security

LFMI took an active stand on policy issues and government decisions related to social security reform. After years of focused policy advice from LFMI, a ceiling was set on social security contributions, seeking to create conditions for fully funded pension insurance in private pension funds. However, the ceiling was removed in October 1999 in an attempt to reduce a growing deficit of the social security budget. In addition to that and despite severe criticism from the expert and business communities, the rate of social security contributions was raised from 31 to 34 percent. LFMI stressed that these were short-term measures that would bolster redistribution within the social security system, eliminate the link between contributions and benefits, increase incentives for shadow employment and undermine opportunities for private retirement provision. LFMI promoted a fundamental revision of the social security system and drew the government's attention to the most needed changes to alleviate the current situation. LFMI recommended eliminating privileged pensions and delegating the collection of social security contributions to the State Tax

Inspectorate. The authorities are now proceeding with preparing the basis for the unification of tax collection. A governmental task force was set up to develop a conceptual framework for a three-pillar pension system, with the state administering the first pillar and providing basic pensions, the second pillar representing mandatory fully-funded pension insurance, and the third pillar being voluntary. LFMI experts are participating in this work.

LFMI monitored other economic policy issues and provided necessary advice, seeking to promote the adoption of sound policy decisions in other sectors and to prevent any steps backwards in Lithuania's transition to a free market economy. LFMI influenced, among other things, policy decisions on enterprise debt capitalization, loan repayment, management and use of state and municipal property, the Civil Code, public organizations and budgetary institutions, residents' income and property declaration, and registration of public organizations.

PUBLIC DISSEMINATION

Mass Media

LFMI actively utilized mass media in increasing the impact of policy recommendations and building community support as crucial elements in implementing and sustaining policy reform initiatives. The advocacy-type of dissemination activities generated over 500 media exposures of various kinds. These included over 370 exposures in print media and 130 appearances on radio and television.

The media appearances included analytical articles, interviews, comments, opinion columns, press releases, quotes and mentions. LFMI published in Lithuania's largest dailies *Lietuvos rytas*, *Respublika*, *Lietuvos aidas*, and *Kauno diena*, in the renowned business newspaper *Verslo žinios*, the financial paper *Litas*, the accounting journal *Apskaita ir kontrolė*, *Mokesčių žinios*, the *Atgimimas* weekly, the Russian-language papers *Echo Litvy* and *Litovskij kurier*, the English-language paper *The Baltic Times*, the Russian-language *Biznes&Baltija*, the *Veidas* magazine, and others. LFMI's articles, policy proposals and interviews were reprinted in many regional papers. LFMI appeared on The Lithuanian radio, M1 and M1 Plus, Radiocentras, and Znad Willi radios, The Lithuanian television, LNK, Tele-3, Vilnius Television, and Baltijos Television.

Newsletter

LFMI published 21 issues of the LFMI newsletter *Laisvoji rinka* (700 copies each) and *The Free Market* (300 copies each). The newsletter highlights the Institute's recommendations on emerging legislation, presents LFMI's research findings and the latest trends in economic policy. The audience of the newsletter comprises business managers and directors, business associations, members of parliament, political leaders, state officials and government executives, including ministries, government agencies, departments and regulatory institutions, counterpart institutes, non-governmental organizations, international institutions, embassies and foreign missions, journalists and reporters, and academia. By advancing viewpoints and ensuring their prompt and wide dissemination, the newsletter acts as a catalyst in stimulating and enriching public debates.